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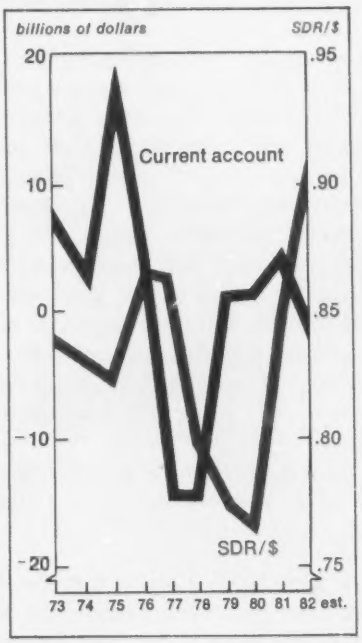
Does Weakening Current Account Portend a Softer Dollar?

The growing consensus that the U.S. current account will move into significant deficit next year has led many analysts to the conclusion that the dollar is likely to weaken as a direct result. They base this supposition on the apparent correlation between recorded data on the U.S. current-account balance and subsequent foreign-exchange values of the U.S. dollar. The problem with this view is that it stems from a "black-box" model—a hypothesis founded simply on correlations. Such a model is inherently unsatisfactory because it does not incorporate a theory of causation. It is true that since the Bretton Woods system of fixed exchange rates was replaced by a floating-rate system nearly a decade ago, the dollar's value has tended to move—with a somewhat variable delay—in the same direction as the U.S. current account. However, the search for a necessary—or even a highly probable—relationship between changes in the U.S. current-account balance and the exchange value of the dollar appears to come up short.

The U.S. current-account balance and the SDR value of the dollar



The fact is that, at least for major swings over the past 10 years, the exchange value of the dollar has responded more to shifts in global preferences for dollar-denominated assets—relative to assets denominated in other currencies—than to current-account developments. These shifts in asset preference, in turn, have been rooted *primarily* in changed perceptions about the tightness of monetary policy in the United States compared with that in other major-currency countries. On the other hand, changes in exchange-rate expectations stemming directly from current-account movements—or from current-account driven charges in the distribution of global wealth—appear to have played a distinctly smaller role in determining the relative preference for dollar assets.

This suggests that in order for the current account to be a reliable predictor of future exchange rates, one of two relationships must hold: Either monetary policy must be driven by current-account developments, or shifts in the relative tightness of national monetary policies must affect goods and services transactions more quickly than they affect asset preferences. Neither proposition is valid. Monetary policy in the United States is not closely related to the U.S. current account. And asset preferences respond much more quickly to perceived changes in the relative tightness of monetary policy than do goods and services transactions. Thus, a deterioration in the U.S. current-account position compared with that of other major-currency countries may or may not presage a fall in the exchange value of the dollar. Only the monetary authorities know for sure!

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Franc devaluation inevitable unless French authorities tighten monetary policy.

French officials are attempting to pin the blame for the recent weakness of the franc on the deterioration of the country's current account. The trade deficit for the first nine months of this year amounted to FF 73 billion—up sharply from FF 38 billion in the corresponding period of last year. Allowing for a declining surplus on invisibles, the current-account deficit may reach some FF 80 billion for 1982 as a whole, following a deficit of FF 26 billion for 1981. Still, a deficit on current-account need not be associated with a falling currency if a country's monetary policy is consistent with its overall balance-of-payments equilibrium. France's loss of reserves is indicative of excess money creation and suggests that the foreign exchange markets view the government's recent austerity measures and price controls as having only a temporary impact on inflation. Nevertheless, the French authorities appear convinced that they can continue to defend the exchange rate and stem the outflow of francs through a range of controls on current and capital transactions without any shift in monetary policy. But unless steps are taken to tighten monetary policy relative to elsewhere in the world, another devaluation of the franc is ultimately inevitable.

Economic policy disagreements spur resignation of Italian government.

Italy's 42nd postwar government has resigned following disagreements within the ruling coalition over economic policy. The main issues are ostensibly the 1983 budget and the stalled three-year wage negotiations—in particular the future of Italy's *"scala mobile"* system of wage indexation. The public-sector borrowing requirement is now expected to equal some 15% of GDP this year, and, assuming no change in policies, is officially forecast to rise to 17% of GDP in 1983. The employers' federation, Confindustria, has announced the unilateral suspension of the *scala mobile*, effective January 31, 1983. However, most observers believe that an agreement will be reached maintaining indexation in an amended form. Meanwhile inflation continues at a year-on-year rate of over 17% and there is no sign of an economic recovery; industrial production in September fell some 5.8% below its year-earlier level. Not unexpectedly, the lira has come under renewed downward pressure and the Bank of Italy has again tightened exchange controls, requiring export financing in foreign currency. All these developments suggest that the next move in Italian interest rates may well be upwards.

Denmark's new government aims tough measures at economic problems.

International concern over Denmark's economy has been mounting over the last few years. The current account has been in deficit for two decades and the country's overseas debts now equal almost 50% of GNP. Denmark's complicated political system and extremely comprehensive and expensive welfare system have hindered the introduction of policies to help correct the problems. However, the new government under conservative Poul Schluter has grasped the nettle and introduced a tough set of austerity measures. Wages and profit margins are to be frozen until next March and after that date increases in public-sector pay and in state benefits will be limited to 4% per year. Government spending plans have also been severely pruned. And most important of all, indexation of wages, salaries, and social security benefits will be suspended until 1985. These measures alone, however, will not be enough to lift Denmark out of its difficulties. What is needed is several years of equally tough policies, and it remains to be seen whether Denmark's political system can support such a program. Nonetheless, the new measures are more courageous than most observers had predicted and should lead to an improvement in the world's assessment of Denmark.

Puerto Rican economy coming out of decline.

A revival of investment activity in Puerto Rico holds promise that the deep economic decline of the past year may be reversing itself. During the fiscal year ending June 1982, Puerto Rican real GNP dropped by 3.9%, the worst performance since the 2% decline of fiscal 1975. All sectors of the economy weakened in fiscal 1982 as a result of U.S. recession, high interest rates, and cutbacks of U.S. government programs for the island. Moreover, uncertainties regarding

legislative proposals for changes in federal tax incentives affecting local investments added to the island's economic problems. The final legislation—incorporated in the U.S. Tax Act of 1982—is considered to have removed these uncertainties by providing clearer rules for investments in Puerto Rico. In the wake of the tax clarification, a number of manufacturing firms have recently announced expansions or new investments. Although these are positive developments, the extent of further recovery will be dependent on the amount of improvement in U.S. industrial activity and interest rates over the next year. With a sufficiently strong revival in the United States, the Puerto Rican economy could return to positive growth by mid-1983.

Foreign investment on the rise in Panama.

The Panamanian government is seeking to further improve the climate for foreign investment in the isthmian country. Total foreign investment has grown impressively since 1979, bringing foreign investors to prominence in Panama's international banking sector, assembly and light manufacturing industries, and the Colon Free Zone, as well as oil transhipment, exports, and Canal activities. Recognizing the value of these investments, the government recently established a National Investment Council to promote more new enterprises. Perhaps even more important to encouraging investment, however, is the recently signed Bilateral Investment Treaty between Panama and the United States. The new treaty, when it is ratified will provide definite rules for the treatment of U.S. investments and assure the continued free movement of capital. Furthermore, the agreement could serve as a model for other developing countries. Currently, the volume of U.S. investments in Panama totals approximately $3.2 billion—third largest in the Latin American-Caribbean region after Brazil and Mexico.

Libya hard hit by world oil glut.

Libya has been one of the OPEC members most adversely affected by the weak oil market conditions of 1981 and 1982. In January 1981, Libya was producing 1.6 million barrels per day and charging an official $41 per barrel for crude oil. By August of that year, production had dropped to 600,000 bd. In October of 1981, OPEC differentials were adjusted, ultimately reducing prices to $37. Production rose, but only temporarily, as world oil demand slumped in early 1982. In March of this year, Libya was assigned an OPEC production ceiling of a mere 750,000 bd and prices were reduced further to $35.50. In recent months, however, the demand for Libyan oil has escalated. Reports currently suggest that production has now reached 1.7 million bd—but on the back of substantial price discounting. These developments have had a serious impact on Libya's balance of payments. Unofficial estimates suggest that 1980's current-account surplus of almost $11 billion turned into a $3 billion deficit in 1981. And for 1982—despite cuts in imports—a deficit of $2 billion is expected. Trade payments difficulties have been reported. However, if current export levels are sustained, these problems should all be settled during 1983.

Weak commodity demand and depressed investment yield lackluster economy for Malawi.

With weak demand for its principal exports of tea, sugar, and tobacco and depressed private investment, Malawi's economy continues to stagnate. Despite some improvement in the balance of payments, as lower imports reflected the slowdown in aggregate demand, external borrowings to finance successive current-account deficits pushed the country's disbursed foreign debt to $700 million by mid-1982—equal to some 70% of GDP. Moreover, Malawi's debt-service obligations rose to over one-third of its foreign exchange earnings. Consequently, debt relief had to be sought and a rescheduling of near-term commercial and bilateral payments obligations is currently proceeding. In addition, the landlocked country's transport situation remains unresolved because of both worsened security on its rail system and congestion at the Mozambican port of Nacala. Although external aid from multilateral sources is expected to continue and there is a possibility of a slight pick-up in inflows of investment capital, the near-term outlook for the Malawian economy remains clouded.

Housing Set for Recovery

Although much of the U.S. economy is sending signals that the recovery may be further delayed, its beleaguered housing industry is beginning to show some definite signs of life. Starts of new housing units edged up to an annual rate of 1.12 million in October—the fourth consecutive month of million-plus performance after lingering below 900,000 for much of the previous year. In addition, sales of new single-family homes jumped to 464,000 in September from an annual rate of 375,000 in August. While these levels are still extremely depressed by historical standards, other changes in the economy suggest that these indicators are bound to improve further and that housing is poised for a modest recovery.

The chief reason the housing outlook now appears more promising is the dramatic decline in mortgage rates over the past few months. The lending rate for government-guaranteed mortgages has dropped to 12% from 15% in August. In response to this, mortgage applications have jumped some 500%.

While financing charges are by far the largest component of the total cost of buying a home, the purchase price is also important. And here, too, prospective homeowners are finally getting some relief. On average, prices of new homes dropped 1.3% in the third quarter—the first decline since 1970—and now are only 2% above their year-ago level. This compares with yearly gains of more than 10% in the late 1970s. In addition, mortgage subsidies offered by many sellers have helped to lower effective selling prices even further.

An imminent return to the housing industry's boom years in the 1970s, however, is unlikely for several reasons. First, this year's markedly lower rate of inflation is likely to continue next year—and may fall even further. Consequently, the portion of housing demand that stemmed from consumers' desire for a hedge against inflation will be virtually nonexistent. Furthermore, with the current 10.4% rate of unemployment unlikely to show much improvement before 1984, many potential homebuyers may be somewhat apprehensive about taking on a long-term mortgage commitment.

Another consideration is that most savings institutions offer only variable-rate mortgages, which are now relatively less attractive given the large drop in interest rates that has already occurred. And in view of their past losses on even the variable-rate mortgages, savings associations may now choose to take advantage of their newly legislated freedom to make more business loans, which would reduce the overall supply of mortgage money.

On balance, however, the prospects of further moderations of housing price increases and some additional decline in mortgage rates should boost housing activity substantially.

Douglas L. Bendt

Europe, Canada & U.S. Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	INDUSTRIAL OUTPUT		GNP IN 1981		BALANCE OF				
		latest data	12-month change	in billions of dollars	real growth	latest data	reserves (less gold) in $ million	12-month change	months of imports covered	use of credit, lions of d
Austria	Reflationary 1983 budget proposed in view of continuing recession and rising unemployment.	July	+ 1%	65.8	+0.1%	Sept.	4,645	+ 7%	2.7	0
Belgium	Government proposes tough budget and incomes policy despite continuing recession.	July	— 1%	96.1	+2.0%*	Sept.	4,460	—14%	0.9	0
Britain	Modest recovery now forecast owing to slight easing of fiscal and monetary policy.	Sept.	0	523.8*	—1.8%*	Sept.	13,263	—13%	1.6	111
Denmark	Strong economic growth continues, but slowdown is expected next year in wake of austerity program.	Aug.	+ 1%	55.9	—0.2%	Sept.	1,830	—25%	1.3	0
Finland	Budget assumption of 2.5% GDP growth after 1% this year is judged to be optimistic.	July	+ 2%	48.5	+1.3%	Sept.	1,041	—31%	1.0	23
France	Industrialists remain pessimistic over near-term outlook.	Aug.	— 3%	657.8*	+0.5%	Aug.	13,867	—41%	1.4	0
Germany	Recession intensifying; official forecast now shows 1% real GNP fall in 1982, zero growth in 1983.	Sept.	— 7%	689.4	—0.3%	Sept.	40,510	—14%	3.1	0
Greece	Economy continues in recession; public-sector deficit overshooting target.	June	—11%	37.7	—0.7%	Aug.	925	+ 4%	1.1	0
Iceland	Reduced fish catches, poor prospects for aluminium exports suggest GNP decline for 1982-83.	n. a.	—	2.8	+1.3%	Sept.	178	—20%	2.0	2
Italy	Coalition government resigns on disagreements over economic policy; recession continues.	Sept.	— 6%	350.6	—0.2%	Sept.	15,611	—18%	2.2	0
Netherlands	New government proposes sharp cuts in spending; output flat while inflation falls.	Sept.	— 4%	140.6	—1.1%	Sept.	8,358	— 1%	1.6	0
Norway	National budget for 1983 aims for 0.8% increase in GNP.	Aug.	+ 5%	55.6	+0.8%	Sept.	6,870	+26%	5.3	0
Portugal	Year-on-year inflation receded to 20.7%.	April	+ 6%	23.5*	+5.5%*	Aug.	701	—19%	0.9	18
Spain	New socialist government not expected to produce radical change of policy.	May	+ 3%	213.1*	+1.2%*	Aug.	9,050	—18%	3.5	37
Sweden	New government raising taxes to match increased expenditures; slight increase in output expected.	June	— 1%	111.6	—0.8%	Sept.	3,218	—21%	1.5	0
Switzerland	Real GDP may decline 1.5% this year.	June	— 2%	99.4	+2.8%	Sept.	13,123	+21%	5.6	0
Canada	Inflation slowing, but unemployment now at 12.7%; real GNP to fall more than 5% this year.	Aug.	—11%	276.4	+3.1%	Sept.	3,027	+40%	0.6	0
United States	Excess inventories lead to continued production declines.	Sept.	— 9%	2,937.7	+1.9%	Sept.	19,845	+ 7%	0.9	0

*1980

Will M2 Growth Slow Enough?

The recently released minutes of the October 4 Federal Open Market Committee meeting confirm that the Federal Reserve has decided to focus relatively more attention on M2 as an indicator of monetary growth. Recent statistics indicate, however, that despite a slowdown from its rapid growth during the summer, M2 is still $11.2 billion above the 9% upper bound of its targeted growth range and, like M1, may easily finish 1982 over target.

The Fed's decision to de-emphasize M1 ostensibly stemmed from its assessment that the more narrowly-defined aggregate was being distorted by technical influences, such as the inflow of maturing All-Savers certificates in October. However, a case can be made that without a change in policy, M1's rapid growth from August thru October—which left it well above its target range—would have forced the Fed to raise interest rates, choking off chances for a 1983 recovery. Thus, the argument that M2 is a more reliable monetary measure is less important to the Fed than the expectation that it will grow more slowly than M1.

M2 contains the transactions balances included in M1 plus such relatively liquid earning assets as money market funds, savings (passbook) accounts, and small time deposits (savings certificates) at banks and savings and loan associations. Therefore, it is reasonable to expect the decline in interest rates that has occurred since July to shift the composition of funds within M2 more heavily into its non-interest-bearing component—M1. This would be the other side of the coin from what occurred in the latter part of 1981, when high interest rates caused M1 to grow at a rate below target, while M2 finished the year above target.

Through October, M2 grew at a 9.6% annual rate, although this average rate masks its well-above-target growth in July and August. And, while the 5.4% and 8.3% rates of growth in September and October, respectively, are still within the Fed's interim targets for this period, it would be inappropriate to interpret this as support for the proposition that declining rates have been slowing M2 growth.

Disaggregated, the M2 data show that over the first 10 months of the year, the level of savings certificates was rising at depository institutions while passbook account balances were falling. The proposition that M2 growth will now slow down is based on the presumption that the trend in savings certificates will be reversed as rates fall, but the downward trend in passbook accounts will be preserved. In fact, however, October witnessed a reversal of *both* trends: savings certificates fell by $8.8 billion while passbook accounts rose by $10.1 billion. What apparently happened was that the maturing All-Savers certificates were not rolled over into new time deposits but instead were deposited into savings accounts. If investors view savings accounts as a liquid medium in which to store precautionary balances while waiting for some resolution of the uncertainty that now characterizes the economic environment, M2 may continue to grow too fast to finish the year within target. *Carl Alan Batlin*

AYMENTS		MONEY AND BANKING							COUNTRIES
		12-month changes				central bank rate△	exchange rate in U.S. dollars		
ars	current influences on payments	latest data	consumer prices	latest data	money supply(M1)	November 17, 1982		current monetary conditions	
	Current account thru August shows 6.8 bn. sch. surplus, vs. deficit year-earlier.	Sept.	+ 5%	Aug.	+ 4%	6.25%	.0557	Interest rates lowered in line with German rate reductions.	Austria
	Trade balance improving despite weak export markets.	Oct.	+10%	March	+ 3%	11.50%	.0201	Interest rates ease.	Belgium
	Current-account surplus up in Oct., projected to be some $5 bn. in 1982.	Oct.	+ 7%	Aug.	+15%	9.13%	1.6050	Bank of England helping rates to fall.	Britain
	Current-account deficit remains about the same as last year.	Sept.	+10%	March	+14%	11.00%	.1112	Austerity program points to fall in interest rates.	Denmark
	Jan.-Aug. recorded 69 million markka trade deficit, vs. 558 million year ago.	Sept.	+ 8%	June	+18%	8.50%	.1739	Markets remain calm following October devaluations.	Finland
	Current-account deficit will widen this year to FF 80 billion.	Oct.	+ 9%	June	+15%	9.50%	.1376	Short-term interest rates cautiously eased.	France
	Current account now in broad balance after 17 billion DM deficit last year.	Oct.	+ 5%	June	+ 3%	6.00%	.3891	Discount and Lombard rates reduced again.	Germany
	Current account temporarily improved owing to oil stock reductions.	Sept.	+20%	April	+16%	20.50%	.0136	Money and credit continue to expand rapidly.	Greece
	Current-account now 10% of GNP—near record proportion.	Sept.	+49%	Aug.	+33%	28.00%	.0625	Monetary policy still accomodating 50% inflation rate.	Iceland
	Current account shows small gain on sharply higher tourism earnings.	Oct.	+17%	June	+ 9%	18.00%	.000676	Renewed lira speculation leads to tighter exchange controls.	Italy
	Weak imports and favorable trade shift prompt rise in current-account surplus.	Oct.	+ 5%	July	+ 6%	5.50%	.3584	Guilder strength permits further interest-rate declines.	Netherlands
	Oil and gas exports of kr 50 bn. keeping 1982 current account in surplus.	Sept.	+11%	July	+10%	9.00%	.1370	Reserve requirements lowered following Swedish devaluation.	Norway
	Current-account deficit was $2.26 billion in first half of 1982.	July	+22%	June	+11%	19.00%	.0108	June M2 growth down to 26.7%, year-on-year.	Portugal
	Peseta weak after election.	Aug.	+15%	July	+14%	8.00%	.00832	August M3 growth eases slightly to 16%, year-on-year.	Spain
	Trade deficit thru Sept. was kr 500 million, vs. 300 million year earlier.	Sept.	+ 7%	Aug.	+11%	10.00%	.1325	Interest rates down slightly after 16% devaluation.	Sweden
	Jan.-Sept. trade deficit was SF 4 bn. vs. SF 6 bn. year ago.	Oct.	+ 6%	July	+21%	5.00%	.4545	Interest rates falling gradually.	Switzerland
	Trade account strong; 1982 may see first current-account surplus since 1973.	Oct.	+10%	Oct.	+ 5%	10.84%	.8163	Interest rates falling even faster than in U.S.	Canada
	Strengthening dollar adds to pressures for rising trade deficit.	Sept.	+ 5%	Oct.	+ 9%	9.50%	—	Soaring monetary growth strains Fed's accomodative stance.	United States

△most recently reported

World Interest Rates

market rates of Nov. 17, 1982; bond yields as of Nov. 12, 1982

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	9.50	10.84	9.125 intervention rate	11.50	9.50	6.00	18.00 penalty rate 21.00	5.50	5.00	5.50
Day-to-Day Money	9.50 November 18	13.00	9.00	11.10	13.125	7.00	18.75	6.125	2.00 1-month Euro-Swiss fr. rate	6.75
Treasury Bills 91-day, Middle Rates	8.36	10.60	8.6875	12.50	n. a.	n. a.	18.249 101 days	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	9.00 finance paper discount basis	10.75 finance paper 15% tax w/h	8.521	11.80 Certified	13.1875 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	8.90	10.75 15% tax w/h	8.75	11.80 Certified	not traded	8.05	19.80	no market	4.50	no market
Government Bonds Long-term, new and old issues, average yield	10.68	12.1875	10.08	n. a.	15.06	8.17	19.96	8.71	4.22	8.122
Industrial Bonds prime, long-term, new and old issues, average yield	11.80 Aa Industrials	13.50	11.52	n. a.	15.90	8.24	19.90	9.13	5.66	6.79
Bank Short-Term Rate to Best Borrowers (prime rate)	12.00	13.00	10.00	16.00	15.20	11.50	20.75 ⅛ qtrly fee on outstdng.	8.00	8.50	6.00
Bank Time Deposits 3-month	9.10 Cert. of Dep.	10.50	9.125	12.50	13.1875	7.05	11.50	6.625 large deposits	3.00 residents only	3.75
Eurocurrencies 3-month, asked	10.00	11.875	9.25	no market	18.125	7.25	no market	6.625	4.1875	7.1875
Exchange Rates—in U.S.$ rates floating against the $	—	.8160	1.605	.0201	.1376	.3891	.000676	.3578	.4556	.00381
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	1.25 *D*	.875 *P*	2.5 *D*	8.0 *D*	2.87 *P*	13.65 *D*	3.5 *P*	6.0 *P*	3.0 *P*

Eurodollar Deposits
(London, interbank, bid)
November 18

7-day	9.625
1-month	9.6875
3-month	9.875
6-month	10.125

International Arbitrage
(3-month, hedged) *+ in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−1.083
U.S.-Canada Treasury Bills	−0.575
U.S.-Canada Finance Co. Paper	−0.353
Eurodollars-U.K. Local Auth. Deposits	+0.125

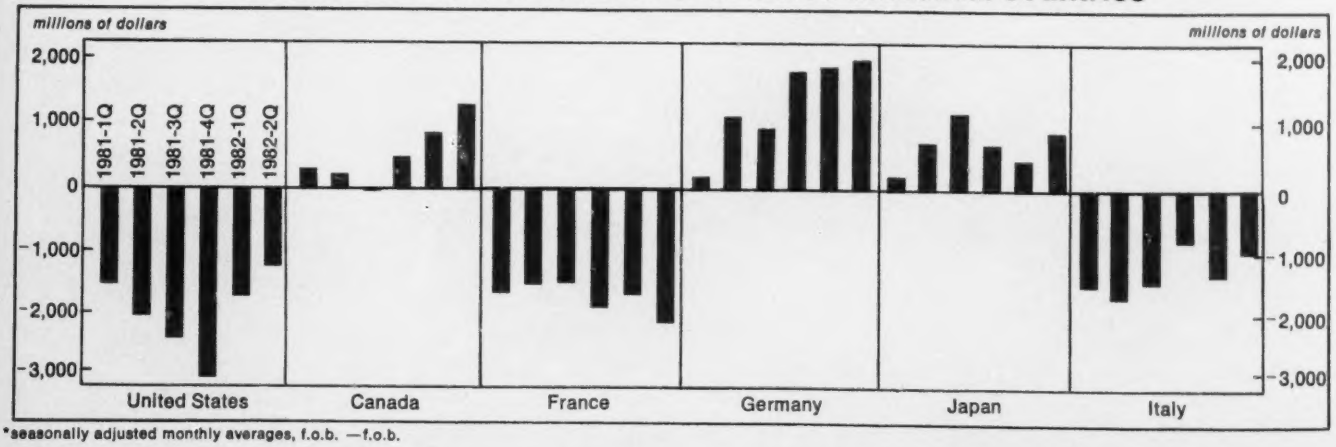
Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	10.75
Over 7 yrs.	11.50
DM Bonds	
7 yrs. and under	7.875
Over 7 yrs.	8.75

Gold Price
London afternoon fixing
412.50
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Merchandise trade balances* of selected industrial countries



*seasonally adjusted monthly averages, f.o.b. —f.o.b.

The High Costs of Protectionist Farm Policies

International skirmishes over trade in farm products are threatening to erupt into all-out warfare. Miffed at what it views as continued encroachments by the European Economic Community (EEC) on its share of the world agricultural market, the United States has warned that it is prepared to institute competitive export subsidies and to dump its multi-billion dairy surplus on world markets unless some steps are taken to limit the EEC's financing of farm exports at below-market prices.

The protracted world recession has raised the United States' long-simmering resentment of European agricultural trade practices to the boiling point. For the first time in more than a decade, the value of U.S. farm exports has declined during a fiscal year. Despite record volume, the value of American agricultural exports in fiscal 1982, according to preliminary estimates by the U.S. Department of Agriculture, fell by some 8% to $40.5 billion. The USDA forecasts that net farm income in 1982 will drop to $19 billion from $24.5 billion two years ago—in real terms, the lowest level since 1933. Although the appreciation of the dollar is partly responsible for the decline in U.S. farm export receipts, the blame for price instability and lost market shares is more often laid on the EEC's Common Agricultural Policy (CAP). And hard times have spawned a protectionist backlash and talk of retaliation against the CAP.

To be sure, EEC policymakers are not the only ones guilty of engaging in "beggar-thy-neighbor" policies in agriculture. Tariffs, as well as export and import quotas and more subtle nontariff barriers to trade—such as agricultural product health and safety standards, packaging and labeling regulations, and specific customs procedures—exist in virtually every country in some form or another. And the current worldwide economic slump is being used as an excuse to erect all sorts of additional barriers. Policymakers often attempt to justify these restrictions as a means of protecting and supporting a nation's farming industry by insulating domestic agricultural prices from lower prices offered by foreign suppliers.

Economists would generally argue that agricultural policies should theoretically be designed to lead to the use of agricultural resources in ways that will minimize the costs of providing food and fiber, taking into account the comparative advantages of different countries. Unfortunately, however, other competing policy objectives—such as maintaining the "family farm" structure, ensuring "equitable" incomes for farmers, obtaining a certain degree of agricultural self-sufficiency, and stabilizing or reducing food prices in urban areas—generally seem to win out over this goal.

According to studies of agricultural protectionism presented at a recent conference on international finance and agricultural trade sponsored by the Global Interdependence Center and the American Agricultural Economics Association, the general policy trend in the industrialized countries has been toward programs that prop up domestic farm prices and restrict imports. This drives a wedge between domestic and world prices, often resulting in overproduction and underconsumption of agricultural output and a massive transfer of resources from consumers to producers. Until the mid-to-late 1970s, the effects of such policies were to some extent contained within the borders of the protecting countries. The problem has been compounded, however, by the dumping of the surplus production at subsidized prices onto international markets. As other countries have resorted to restrictive import quotas or some other means of protecting their home markets, the efficient exporting countries have borne the burden.

In the developing countries, on the other hand, farm policies frequently discourage agricultural output by imposing export taxes, government controlled licensing arrangements, price controls, and mandatory storage requirements. Such policies are often defended on grounds of maintaining price stability. However, their effects are generally overconsumption and underproduction of farm output and, frequently, increased price volatility.

The budget costs and true costs to consumers of such policies are never clearly specified—if they are even estimated. And the overall result is often a world in which industrialized countries are overburdened by massive food surpluses at the same time critical food shortages exist in many developing countries.

Expensive policies

The EEC's CAP perhaps is the most highly criticized agricultural support program because of the market-distorting effects of its policies. The CAP subordinates international trade in farm products to domestic producer price considerations through a complex system of tariffs and variable levies. An internal price is politically determined for each of the agricultural products governed by the program (about 90% of EEC output is covered). That price is then maintained through the imposition of variable levies on imports equal to the difference between the "threshold price" and the world price. In this way, would-be exporters to the Common Market are effectively shut out. It has been estimated that the effect of the CAP in terms of lost market shares for countries supplying the EEC over the years 1962-79 totaled some $28.7 billion in 1980 dollars. Broken down by those countries affected, this amounted to a loss for the indus-

The High Costs of Protectionist Farm Policies *(continued from page 7)*

trialized countries of: $2.8 billion for the United States, $2.3 billion for Canada, $4.7 billion for Australia, and $7.6 billion for New Zealand. Developing countries, on the whole, lost some $9.2 billion—almost one-third of the total. This loss of market share, as well as the commodity-price instability caused by CAP policies, has been frequently cited as an important contributor to the developing countries' difficulties in servicing their debt burdens.

As more-efficient, lower-cost foreign producers of farm products are excluded from EEC markets, European consumers also suffer. According to some estimates, EEC consumers have paid as much as five times the world price for milk powder, four times the world price for butter; two-and-a-half times the world price for beef, and one-and-a-half times the world price for grain. More recent statistics indicate that the gap between EEC and world food prices has narrowed somewhat but is still quite wide compared with those of most other countries.

The CAP includes no controls on production, and—because internal Common Market consumption of most of its farm products is stagnant or falling—huge surpluses have arisen. The EEC either subsidizes inferior end-users of the products at home or exports its costly excesses through subsidized sales that enable it to undercut other exporters. In fact, through its subsidized exports, the EEC has greatly expanded its share of the world's agricultural export markets. It is now the world's second largest exporter of beef and for many years has been the largest exporter of dairy products—even with producer prices some two and three times, respectively, the level of the world's efficient producers. Sugar provides an even more dramatic example. Although the commodity is produced at lowest cost in the tropics, the EEC has emerged as a leading sugar exporter—second only to Cuba.

The price of self-sufficiency

Japan is another country whose farm policies have come under strong attack. Achieving and maintaining a certain level of agricultural self-sufficiency has long been a predominant policy goal—one that has proved costly to Japanese consumers. As a result of its program of price supports, input subsidies, and import controls, Japanese families spend some 32% of their disposable income on food, compared with 20% for Europeans and 17% for Americans.

The Japanese government is extensively involved in planning and regulating the agricultural sector. For example, beef production is protected by an annual import quota and a 25% ad valorem tariff; pork prices are stabilized by government purchases and sales of stocks and by a variable duty on imports; a 35% tariff is imposed on imports of poultry, eggs, and dairy products; and a government agency is the sole buyer and seller of domestic and imported food grains, setting farm purchase prices and resale prices markedly different from world levels. Moreover, although the gradual Westernization of the Japanese diet has led to a fall in the consumption of rice, this traditional staple has remained the mainstay of agriculture thanks to support prices paid to farmers equal to about twice the level of world prices. Because of the administered prices, the Japanese government—like the EEC—has been forced to dispose of the surplus rice produced not only by diverting to livestock feed, but also by subsidized exporting. This has heightened trade tensions between Japan and commercial rice exporting countries, in particular the United States.

Although the United States has recently become more vocal in its criticisms of other countries' agricultural policies, its own farmers are hardly left unprotected from the vicissitudes of the market. The United States has price support programs for a number of farm products—including wool, wheat, cotton, corn, rice, soybeans, sugar, peanuts, tobacco, and dairy products—which frequently result in unwanted surpluses. America also subsidizes its farmers in other ways such as grain storage payments, marketing orders, low-interest loans, and export credit programs.

World agricultural markets are further distorted by the policies of the developing nations. Price controls on domestic sales, export taxes, government import monopolies, selective distribution systems, and mandatory set-aside programs are among the commonly used programs. With many of these programs, however, the effect—contrary to the policies of the industrialized countries—is to discourage agricultural production. Direct price controls are frequently used to maintain consumer prices below the free-market level. But while these policies succeed in keeping retail prices low, they reduce farmers' incentives to produce. One of the economic costs of inadequate domestic food production is a rising import bill—a situation many developing nations can ill afford.

What is often ignored by agricultural policymakers is the vital role that market-determined farm prices play in achieving optimum output, growth, trade, and food-supply security. It is doubtful that the trade ministers attending the General Agreement on Tariffs and Trade meeting in Geneva later this week will take any substantive action toward dismantling the protectionist policies that prevent the price mechanism from doing its job. Indeed, real changes in policy are unlikely to come about until policymakers acknowledge the extent to which they are distorting resource allocation and lowering living standards for their societies as a whole in order to protect the interests of a few favored groups.

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